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It’s a Miserable Life

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Last week the scene at branches of Countrywide Bank, with crowds of agitated depositors trying to withdraw their money, looked a bit like the bank run in the classic holiday movie “It’s a Wonderful Life.”

As it happens, Countrywide’s customers were overreacting. True, the bank is owned by Countrywide Financial, the nation’s largest mortgage lender — and mortgage lenders are in big trouble these days. But bank deposits up to $100,000 are protected by the Federal Deposit Insurance Corporation. Old-fashioned bank runs just don’t make sense these days.

New-fashioned bank runs, on the other hand, do make sense — and they’re at the heart of the current financial crisis.

The key to understanding what’s happening is taking a broad view of what constitutes a bank. From an economic perspective, a bank is any institution that offers people liquidity — the ability to convert their assets into cash on short notice — while still using their money to make long-term investments.

Traditional banks promise depositors the right to withdraw their funds at any time. Yet banks lend out most of the money depositors place in their care, keeping only a fraction in cash. The reason this works is that normally a bank’s depositors want to withdraw only a small proportion of their money on any given day.

Banks get in trouble, however, when some event, like a rumor that major loans have gone bad, leads many depositors to demand their money at the same time.

The scary thing about bank runs is that doubts about a bank’s soundness can be a self-fulfilling prophecy: a bank that should be safely in the black can nonetheless fail if it’s forced to sell assets in a hurry. And bank failures can have devastating economic effects. Many economists believe that the banking panic of the early 1930s, not the stock market crash of 1929, was the principal cause of the Great Depression.

That’s why bank deposits are now protected by a combination of guarantees and regulation. On one side, deposits are federally insured, and the Federal Reserve stands ready to rush
cash to troubled banks if necessary. On the other side, banks are required to keep adequate reserves, have adequate capital and make conservative loans.

But these guarantees and regulations apply only to traditional banks. Meanwhile, a growing number of unregulated bank-like institutions have become vulnerable to the 21st-century version of bank runs.

Consider the case of KKR Financial Holdings, an affiliate of Kohlberg Kravis Roberts, a powerhouse Wall Street operator. KKR Financial raises money by issuing asset-backed commercial paper — a claim that’s sort of like a short-term C.D., used by large investors to temporarily park funds — and invests most of this money in longer-term assets. So the company is acting as a kind of bank, one that offers a higher interest rate than ordinary banks pay their clients.

It sounds like a great deal — except that last week KKR Financial announced that it was seeking to delay $5 billion in repayments. That’s the equivalent of a bank closing its doors because it’s running out of cash.

The problems at KKR Financial are part of a broader picture in which many investors, spooked by the problems in the mortgage market, have been pulling their money out of institutions that use short-term borrowing to finance long-term investments. These institutions aren’t called banks, but in economic terms what’s been happening amounts to a burgeoning banking panic.

On Friday, the Federal Reserve tried to quell this panic by announcing a surprise cut in the discount rate, the rate at which it lends money to banks. It remains to be seen whether the move will do the trick.

The problem, as many observers have noticed, is that the Fed’s move is largely symbolic. It makes more funds available to depository institutions, a.k.a. old-fashioned banks — but old-fashioned banks aren’t where the crisis is centered. And the Fed doesn’t have any clear way to deal with bank runs on institutions that aren’t called banks.

Now, sometimes symbolic gestures are enough. The Fed’s surprise quarter-point interest rate cut in October 1998, at the height of the crisis caused by the implosion of the hedge fund Long-Term Capital Management, was similarly a case of providing money where it wasn’t needed. Yet it helped restore calm to the markets, by conveying the sense that policy makers were on top of the situation.

Friday’s cut might do the same thing. But if it doesn’t, it’s not clear what comes next.

Whatever happens now, it’s hard to avoid the sense that the growing complexity of our
financial system is making it increasingly prone to crises — crises that are beyond the ability of traditional policies to handle. Maybe we'll make it through this crisis unscathed. But what about the next one, or the one after that?